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¶1. (SBU) Summary: On May 27, a visiting IMF Article IV team briefed interested donors. While not changing their projected 2009 growth rate from 4.5%, the team noted that the Government of Laos (GOL) must make tough choices in the next 18 months to avoid putting macroeconomic stability at risk. Policy changes are required to lower a budget deficit now grown to an estimated 8% of GDP, and off-budget expenditures by the Bank of Laos should be minimized. Credit growth, which expanded 80% in the last year, must be slowed to ensure that a new wave of non-performing loans (NPLs) does not once again bankrupt the state-owned commercial banks. The government has approached donors, such as Japan and Korea, to request concessional budget support and is so far striving to minimize spending cuts. End Summary.

¶2. (SBU) An IMF team, led by senior economist Susan Baker from Washington, DC and including senior resident representative Benjamin Bingham, visited Laos for two weeks in May for Article IV consultations with the GOL. On May 27, the team gave a short briefing for donors to sketch the results of the confidential discussions. The Article IV report should be finished by early July, and will be published soon afterwards if the GOL concurs (which it has the past few years). According to the team, this mission, which examined a broader range of economic indicators than during a March visit (reftel), continues to expect 2009 economic growth of 4.5%, which should jump to 5% in 2010 as a result of the Nam Theun II dam beginning operations.

¶3. (SBU) After forecasting a resumption of global growth in 2011, the team stated that the next 18 months would be "quite challenging" due to dangerously expansionary fiscal and monetary policies by the GOL, which the IMF believes places macroeconomic stability at risk. Large off-budget expenditures, directly financed by the Bank of Laos, for the South East Asia (SEA) Games and the 450th Anniversary of Vientiane, are contributing to a growing fiscal deficit now estimated at 8% of GDP (versus 6.5% in March). If the off-budget items are not counted, the deficit is approximately 5.6% of GDP. Ms. Baker noted that foreign reserves have already dropped by $100 million over the past year, with a continued drop forecast unless the government cuts expenditures. (Note: This drop would indicate reserves of about $689 million, based on available information. Reserves now are about twice what was available in 2006. End note.) Despite this drop, the team suggested that reserves continue to equal about 5 months of imports, although they noted that projected imports had also fallen in their models. As reserves fall towards three months of imports, the IMF believes the chances of an exchange rate shock will rise.

¶4. (SBU) According to the IMF, the deficit has increased primarily due to increased new spending, not a greater than expected shortfall in revenue. Credit growth, primarily at the state-owned commercial banks, is up 80% in the past year. The quality of these loans is in doubt--private banks told the IMF they were not seeing a large increase in profitable projects, and the state-owned banks themselves are not known for quality risk management. Combined with the BOL's off-budget financing operations, the IMF team told the donors it was worried the GOL would avoid cutting spending in light of the large ongoing public projects and the government's insistence that the economy will grow at 7.5% in 2009.

¶5. (SBU) COMMENT: Although constrained by confidentiality, the IMF team's message was clear -- the GOL is spending beyond its means and could soon find itself with dangerously low foreign reserves and a banking sector burdened with large numbers of non-performing loans. An exchange rate shock, and the loss of macroeconomic stability, is a possibility. Although the recommended policy choices do not appear overly burdensome -- cut the deficit by 1.5% and slow credit growth -- it is likely the GOL will search for donors to help cover the fiscal gap while simultaneously hoping the IMF's prediction for stronger global growth in 2011 produces enough revenue to counter any difficulties. There has been little interest among most donors in extending serious budget support, although both Korea and Japan have been approached by the GOL and, along with China, are the most likely contributors. End Comment.
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